The New International Architecture: Is There a Workable Solution?

Andrew Sheng*

I. Global Crisis—National Laws

Two years after the devaluation of the Thai Baht, the Asian crisis looks like a bad dream. The pain remains and adjustment continues, but the speed of restoration of the external account indicates that panic capital flight was as much to blame as domestic fragilities. In less than two years, Korea, Thailand, and Malaysia have swung from current account deficits of over five percent of GDP to surpluses of over twelve percent of GDP.

In hindsight, the Asian crisis was not an Asian crisis: it was first and foremost a crisis of global markets that raised important issues of international law, geopolitical economy, and the philosophy of global markets. To put it simply, under a domestic political governance architecture, we have the classic Montesquieu trinity of checks and balances between the executive, legislature, and judiciary. The same framework does not exist for the current international financial architecture. There is currently no functioning global executive, global legislature, or judiciary, nor is there a consensus on the conceptual framework of such architecture, even though a pragmatic but somewhat loose status quo exists.

From the perspective of international law and regulation, the crux of the current complexity lies clearly in the reality that there are global markets, but only domestic laws and regulations, nor is there adequate global administrative machinery to deal with a global crisis. The cliches of the Asian crisis are now all old hat: lack of transparency, over-leverage, crony capitalism, poor bank supervision, and flawed policies. However, if you sift carefully through the evidence of financial fragility, poor information, and poor risk management, it all boils down to the question of governance: not just governance at the corporate level and the financial market level, but at the national and international government levels.

But then, once we make this leap into the unknown, are we talking about governance within geographical territory, jurisdiction, or borderless cyberspace? How do you deal with domestic policies and actions that have global repercussions, or global shocks that have domestic costs? Moreover, can we (or should we) regulate players who can move billions across borders in micro-seconds, wreaking collapses of weak domestic banking systems and

*Andrew Sheng is Chairman of the Securities and Futures Commission.

setting growth back almost a decade? Within individual jurisdictions, there is no consensus on how to deal with such market concentrations, risks, or imperfections, let alone across multi-jurisdictions.

II. Macro-economics Versus Micro-structure of Markets

For all the finger pointing on who was to blame for mishandling the Asian crisis, the problem was not that Asia did not, on the surface, look macro-economically sound. After all, Asia had a high growth rate, high savings rate, the highest reserves in the world, no inflation to speak of, no noticeable fiscal deficits, no overall balance of payments deficit, and met Basle capital adequacy guidelines (on paper). However, in a couple of months, there was a crisis that reverberated from Asia through Russia to the rest of the world.

In hindsight, the devil was in the details. Most national and international policy makers, including the International Monetary Fund (IMF) which has the best macro-economists in the world, had good training in macro-policies but very little understanding of the micro-structure of markets. Modern financial markets have very complex micro-structures that encompass the trading of property rights via outmoded legal and regulatory frameworks, uneven accounting standards, and a mix of slow paper-based and high tech, high speed computer systems and processes. Many of these creaky domestic market structures were simply not designed to stand the stresses and risks of large global capital flows. Such structures are neither consistent within markets, nor between markets.

IMF Managing Director Michel Camdessus used to say that the Mexican crisis was the first crisis of the twenty-first century. Technology, financial innovation, and deregulation moved faster than the international legal and regulatory framework. The lack of clarity of protection of cross-border property rights created panic capital flight with which domestic authorities could not cope. Central banks evolved in the nineteenth century into institutions designed to deal with domestic banking crisis. But the IMF was neither designed nor mandated as a global central bank to deal with international banking crisis. In short, we are dealing with the crises of the twenty-first century with fire engines that are at least fifty years old.

III. The Legitimacy of the International Architecture

The present international financial architecture is a patchwork of different international bodies with unclear mandates, jurisdictions, and powers. The structure is loosely divided into three groups. First, there are multilateral agencies with formal bureaucracies, such as the IMF, World Bank, BIS, and OECD. The second group mainly comprises the policy formulation groups and loose regional or international coalitions of national authorities, such as central banks and treasury officials of G-7, G-10, G-22,[1] and the European Union (EU). The third group is composed of international regulatory and standard setting authorities, such as the Basle Committee on Banking Supervision, International Association of Insurance Supervisors (IAIS), International Organization of Securities Commissions (IOSCO), International Accounting Standards Committee (IASC), Institute of International Finance (IIF), and the Group of Thirty (G-30).

1. I was privileged to participate in the G-10 working paper on financial stability, particularly in emerging markets, and also co-chair the G-22 working party on transparency and accountability.

Two trends are clearly emerging from the present debate. First, the big boys need to talk to the smaller constituents to preserve legitimacy of their jurisdiction. Second, the policy authorities are finally beginning to admit that the private sector knows more about the market than they do.

At the recent IOSCO Annual Conference in Lisbon, Michel Camdessus described the key elements of the new international financial architecture as transparency, crisis prevention, freedom of capital flows, global standards, and codes of practice.[2] But while we can all agree on the need for a new global architecture, we have not addressed the fundamental issue of due process. How do we create the right due process in the formulation of international standards, codes, and financial law? Moreover, what appropriate international institutions are needed in order to implement, adjudicate, and enforce such standards of practice, codes, and law? These remain extremely complex issues of political economy.

To address this issue, we need to go back to what the functions of financial markets are, and why we need financial markets to function properly. The first function is the allocation of real resources. Resource allocation is an economic term, but financial markets help the exchange of property rights and that is a legal issue. How do you define these property rights? Who protects these property rights?

The second function of financial markets is to allow consumers to delay their consumption and save in financial products. The third function is risk management. Financial markets allow the diversification of risks. Many derivatives involve the swapping of property rights in order to diversify risks.

Fourth, financial markets have a role in corporate governance. This is all about the principal-agency problem: how do you ensure, as a minority shareholder, that the agents —the management and the majority shareholders who are supposed to manage your assets for you—are doing it in a trustworthy manner?

Finally, financial markets perform a price discovery function to assist with the valuation of property rights. But increasingly, we have become aware that asset prices depend on the way that assets have been financed by liabilities. Assets financed mainly by leverage have higher volatility of values, while assets financed wholly by equity need not be liquidated in a hurry and therefore can have more stable values over time.

Like an onion, all these issues are superficially in the realm of economics. But if we peel off the first layer, they are in the realm of law. If you delve a little bit deeper, they are in the realm of politics. Finally, at the core is the realm of philosophy.

When the Asian crisis first hit, the G-10 economies, which traditionally run the global economic policy, began to realize that global markets were larger than their political sphere of influence. Therefore, they had to broaden the legitimacy of their decision-making on behalf of the world through G-22. However, after a lot of protests from within and without, including the smaller markets that felt excluded, the group was widened.

In March, IOSCO hammered out a compromise called the Financial Stability Forum (Forum), which is a designated coordinating body. The Forum comprises various national bodies or authorities, including BIS, IBRD, IMF, OECD, IOSCO, International Institute of Insurance Supervisors, and the Basle Committee. Its mandate is to assess the vulnerabilities of global markets, identify, oversee action, and improve coordination and infor-

2. *See* Michel Camdessus, Stable and Efficient Financial Systems for the 21st Century: A Quest for Transparency and Standards, Address at the IOSCO Annual Meeting (May 1999).

mation exchange.[3] Notice that this is only a coordinating body, not an enforcement or standard-setting body.

The first hot potato that is being looked at by the Forum is highly leveraged institutions. The role of the hedge funds in recent crises has aroused a lot of emotion but raised a fundamental problem of a level playing field in markets (what I call the "elephant in the pond" problem). How do you deal with highly leveraged institutions with large funds that operate in small illiquid markets? A rogue elephant can create havoc, but even a benign elephant can squash the small fry in a pond with the best of goodwill.

The President's Working Party on Financial Stability reported that hedge funds today have $1 trillion in assets with a leverage power of up to 25 times.[4] By comparison, U.S. banks have $8 trillion in assets with a leverage power of only 12.5 times.[5] Fully leveraged in derivatives, the hedge funds have the potential to outgun any emerging market, with no global rules to prevent this from happening.

When hedge funds led the pack of excessive speculation against the Hong Kong dollar, some market fundamentalists[6] thought that we were committing the ultimate cardinal sin, which was . . . how can the freest market in the world intervene?

Our reply was: if you had a situation like the Hunt brothers in the cornering of the silver market, you had U.S. antitrust laws to deal with U.S. citizens who had engaged in financial misconduct. However, how do you deal with potential market misconduct if two or three offshore players were large enough to destabilize a particular market in another jurisdiction? Hong Kong intervened to stabilize the market at a point of time when excessive speculation by a few players could have destabilized the market with catastrophic consequences, not only for the Hong Kong economy, but also international markets. In September of last year, the fact that a hedge fund as large as LTCM could create systemic risks in as deep a market as the United States implied a serious gap of information on market leverage and concentration, by players and regulators alike. How do we minimize the costs of market disruption from the activities (ranging from benign hedging to collusion with intent to manipulate) of large players in smaller markets? Markets work best with level playing fields. However, if some players are excessively large relative to smaller emerging markets, how do we create a "fair," level playing field for all participants? Should we have antitrust type regulations on a global basis? Or would a market disclosure regime, where all players alike know of the position size of major players, be adequate? In addition, what type of laws and regulatory mechanisms will deal with this issue?

The other issue being studied by the Forum is offshore centers. Offshore centers survive because of tax, legal, and regulatory arbitrage. If one jurisdiction taxes you heavily or prohibits an activity, you simply move offshore. However, transactions in a domestic economy that are launched from the safe haven of an offshore center and lead to a financial crisis create an interesting question. The local authorities that had to pay for the losers do not have the capacity to tax the winners. In a zero sum game, a gain offshore would mean a loss onshore. You have global gain, but local pain. In the short run, local constituencies would accept the price of adjustment in order to gain the benefits of free trade. But repeated

3. *See* Andrew Crockett, Promoting Stable and Efficient Financial Systems, Address at the IOSCO Annual Meeting (May 1999).

4. *Id.*

5. *See id.*

6. Jeff Madrick, *The International Crisis: An Interview*, N.Y. REV. BKS., Jan. 14, 1999 <http://www.nybooks.com/nyrev/wwwarchdisplay.cgi?19990114036F> (term used by George Soros).

global financial crises, without an equitable redistribution mechanism, would be politically unsustainable in the long run.

IV. Who Gains? Who Pays in Globalization?

The political economy of financial crisis really boils down to who pays for the economic and social losses of crises. The Bretton Woods international financial architecture was designed in the 1940s for an orderly adjustment process for global free trade within a fixed exchange rate regime. The Bretton Woods institutions help share the burden of adjustment. But today, their share has become very small, because private financial markets are the major creditors of emerging economies.

In a domestic financial crisis, the borrower who defaults and is made bankrupt sustains the loss. If the bank or lender cannot recover the full loan, the bank pays. If the bank goes into bankruptcy, either the depositor pays or the deposit insurance pays. If the government underwrites the losses of the financial crisis, ultimately the taxpayer pays. However, if the government finances the costs through printing money, then the consumer pays through the inflation tax.

However, if the government decides to devalue, it's the trading competitors who share in the costs of the crisis. One of the arguments for flexible exchange rates is that the economy manages its risks better than one with a fixed exchange rate regime. The problem is that a devaluation transfers part of the domestic losses to the external sector. However, if everyone devalues at the same time, we return to status quo. Thus, the exchange rate regime is also a channel through which the costs of internal adjustment are either borne through domestic reforms in a fixed exchange rate regime, or shared internationally through devaluation. The Bretton Woods era assumed that competitive devaluation was not helpful, and established the Bretton Woods Institutions to share the burden of adjustment. Fifty years later, the political economy question of who bears or shares the costs of adjustment still has not been resolved.

Currently, the costs of financial crisis have been largely borne by the affected economy, with some aid through IFIs. It remains true that no global taxation exists to help share domestic economic losses, most of which have been internalized and deferred for the next generation to pay. There is also no consensus on how that taxation should be agreed upon and levied.

In essence, there is no agreed-upon legal due process on how global economic losses could be addressed or apportioned on an equitable or democratic basis. We come back to the fundamental problem that we have global markets but, unfortunately, national laws and regulations. Even the measurement of economic gains and losses, which rely upon standards, do not have consensus. There are cultural, legal, economic, and historical differences in standards, codes of practice, rules, regulations, and laws.

The issues are particularly complex because of the negative externalities of globalization, as we dispute the impact of pollution, water, and other rights that transcend national borders. Even in areas where one would have thought standards would be simple, such as accounting standards, there are huge differences in interpretation, adjudication, enforcement, and due process.

The reason why I think that the international financial architecture is so controversial is that once we realize that there is a need for global standards, there is a need for convergence. But how do we agree on the process of convergence, which is a question of political economy?

What the global financial architecture is all about is the direct implication of global markets. This requires a global legal, accounting, and court infrastructure to protect, delineate, and adjudicate property rights that are transferred internationally. To do this properly, you need international cooperation to evolve international law. We need agreed standards of measurement, reliable and timely information, and agreed upon incentives (such as standards of behavior and compliance). Moreover, one needs global monitoring and surveillance, a mechanism to enforce responsible and sound macro-economic behavior that does not impinge costs on others, and intensified cooperation and coordination.

The creation and maintenance of such a global architecture has costs, but realistically there is no global tax to pay for such an architecture, nor a mechanism to allocate the costs of global crisis. Just as competitive devaluation and resulting deflation in the 1930s created global conflict, such conflicts will arise even more in an increasingly globalized financial and trading environment.

V. Gaps in Global Markets

It has been forcefully argued that the Asian crisis was due to gaps of disclosure in material information. The G-22 Working Group on Transparency and Accountability addressed two fundamental gaps: the gaps in information disclosure and gaps in incentives to use information. While not all the information on external debt and corporate over-leverage was readily available, there is no question that, even prior to the Asian crisis, a lot of information was available to bankers and investors alike to predict the crisis. They chose to ignore it. They ignored the warning signs because of the herding effect of competition to lend or invest in the Asian market, which unfortunately reversed in the same speed.

However, there were two other gaps that are disturbing. The third gap is the gap in GAAP, or Generally Accepted Accounting Principles. As we all know, the International Accounting Standards are not yet adopted internationally, mainly because of differences with U.S. GAAP.

The fourth gap, from the emerging market point of view, is much more serious: namely, the gap that results from the incapacity to understand information. Technology and financial innovation have not only outpaced the advanced markets, but have considerably widened the gap between emerging and advanced markets. An emerging market regulator can legitimately question why he needs to adopt global standards on derivatives, when he can say, "I don't understand anything about derivatives; we don't have derivatives in my market. Why do we need this new law on derivatives?"

The reality is that derivatives will arrive in local markets through technology and competition. For example, Internet technology has undercut intermediation and traditional franchises. The recent book by McKinsey consultants, *Banking in Asia: The End of Entitlement*, demonstrates convincingly that banking failures in Asia occurred because the traditional franchises were disappearing. Domestic banks, financial intermediaries, and regulators have to be aware that the gap in technology and capacity to compete—indeed, the knowledge gap—must be narrowed. Otherwise, the consumer will gain, but the traditional banks in Asia will disappear within the next ten years through failure, consolidation, merger, or acquisition.

VI. The Political Economy of Global Markets

To put it crudely, the political economy in the new global financial architecture is about who will set the global standards, who implements and interprets these rules, who enforces the rules, and who adjudicates disputes. The unfortunate answer is that there is no answer at the present moment. We are at the historical time line of what may be called the Magna Carta of global markets—no taxation without representation.[7] The global architecture cannot be decided by the votes per capita, since the emerging markets would have an overwhelming say. It will ultimately be decided by market power, however, that has yet to be defined.

What can the smaller emerging markets do to prepare for the New International Financial Architecture? When we use the word "architecture," it would be helpful to think about financial markets as networks. Networks have positive and negative externality. Volatile capital flows can be thought of as power surges across the network. Those hubs in the global network that were designed to take only four standard deviations in volatility when a fifteen standard deviation volatility occurred would "blow a fuse." When one component of the network blows a fuse, someone loses and, if we are not careful, the whole network can come down. Hence, nervousness about the global architecture results.

Thus, the stability and the resilience of the global network are only as robust as its weakest hub, i.e., the lowest common denominator is the domestic network. Consequently, joining the global network carries an implicit responsibility to strengthen the domestic network. Since we cannot solve the global problems currently, charity must begin at home. The first step is to build strong economic and financial fundamentals at home. One needs to build fair, efficient, and transparent markets with sound regulations meeting international standards in order to meet global competition.

VII. Conclusion

Globalized markets bring benefits, but also carry huge risks and challenges to domestic economies. Federal Reserve Deputy Chairman Alice Rivlin summed up the challenges very well.[8] She explained that in a world with global competition, we need flexible and adaptable businesses that can take risks. Similarly, we need workers and communities that must be willing to take risks, learn new skills, and acquire the knowledge to compete globally. At the same time, communities must diversify their economic bases and governments must be creative and supportive to help the communities make the transition to global markets.

All this creates a very fundamental question of the lack of global laws. How the law tries to define and protect property rights in a very flexible, volatile, and changing global environment is the real challenge that the world and this conference will have to address. The economic and social losses of the Asian crisis are huge by any standard. Perhaps crisis and pain is part of the process of growing up. We cannot totally prevent crises or making mistakes, but we should learn from them.

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7. *See* Andrew Sheng, Closing Remarks at the World Bank-Brookings Institution Conference on Financial Markets and Development (Mar. 1999).

8. *See* Vice Chair Alice M. Rivlin, On Sustaining U.S. Economic Growth, Address before the "Minnesota Meeting" Group (May 13, 1999) <http://www.bog.frb.fed.us/bocrddcs/speeches/1999/19990513.htm>.